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LONG-RUN RANGES
Donald L. Kohn

At this meeting the Committee is called on to review its long-run ranges for money and debt for this year and to set ranges on a provisional basis for 1992.

The choice of ranges can be thought of as conditional on three basic considerations: the objectives of policy, the underlying forces and risks in the economy as they bear on reaching these objectives, and the relationship of money growth to a given path of spending and income.

The first set of considerations is addressed in the simulations of alternative strategies in the bluebook, whose results are given on page 9. The strategies represent three fundamental approaches to policy in the next few years: one that emphasizes increases in output and declines in unemployment (Strategy III), one that puts stress on consolidating recent gains on inflation and moving close to price stability in 5 years (Strategy II) and one that takes something of a middle road by making gradual progress on both inflation and unemployment (the baseline strategy I); Strategy IV is a variant of the baseline, which emphasizes output early on and prices somewhat later.

The possible outcomes that different strategies can produce depend importantly on the starting point for the economy, including any developments already built in for the near term, more or less independent of the monetary policy path followed in the months immediately ahead. In that regard, we are starting from a condition of slack in the economy, and consequently can expect a near-term deceleration of inflation under any approach. The degree of slack is not especially large compared to past recessions, however, and could be reduced by the near-term bounceback in activity.

This situation has several consequences illustrated in the simulations. First, if policy attempts to push unemployment down rapidly and significantly, as in Strategy III, progress in reducing inflation will be very limited, and could be reversed in a few years unless the additional ease were offset after only a few quarters, as in Strategy IV. Second, because the existing degree of slack is modest, any drop in unemployment will allow only fairly modest progress on inflation. Strategy II, aimed at approaching price stability over 5 years, entails very small declines in unemployment now and an increase later; of course, these latter results do not embody credibility effects, which might allow significant declines in both inflation and unemployment after this strategy had been in place for a time.

The tendency for inflation to persist also implies the need for policy to accommodate some pickup in nominal GNP growth in 1992 relative to the last few years if unemployment is to be reduced. Indeed, one could characterize the tighter strategy as one that holds down money growth to resist any such near-term pickup, and enforces decelerating nominal GNP growth from 1993 on. The easier strategy is accomplished by raising nominal GNP growth to about 7 percent in 1992 and keeping it there; the baseline increases nominal GNP growth to 6 percent in 1992, then gradually reduces it thereafter.

The path for money that can accommodate the Committee's objectives for prices and output depends on an assessment of the second and third sets of considerations--the underlying forces working on spending and prices, and the underlying relationships of money to spending. With regard to the former, as Mike and Ted detailed, the staff forecast sees essentially flat nominal short-term interest rates producing gradually declining unemployment and inflation rates. The continued improvement in price performance occurs because the level of real rates implied by the nominal rates is sufficiently high, given all the damping forces Mike discussed, to keep the economy from rebounding all the way to its potential; that configuration has been extended in the baseline forecast. Obviously, a weaker economy would imply the need for lower interest rates to meet any set of objectives, and a stronger economy higher interest rates. Changing interest rates, in turn, by influencing opportunity costs and velocity, would affect the money growth needed to achieve the Committee's objectives. In this regard, the money ranges should give sufficient scope to deal with potential deviations from expectations; the choice of ranges itself can convey some sense of how the Committee sees the risks, as well as how, in the context of its objectives, it would react to particular types of unexpected developments.

What money goes with a particular path for spending depends not only on the associated movements of interest rates, but also any changes in underlying relationships of money to income. While unexpectedly sluggish money growth has presaged shortfalls in nominal spending over the past year, the full extent of the weakness in money has not been reflected in nominal GNP, at least based on historical patterns. Velocity has declined over the last three quarters, but not by as much as would be expected when effects of the drop in interest rates are taken into account.

The reasons for this remain something of a mystery. They probably involve the declining importance of depositories in the intermediation process--a secular trend, arising from technological change and fuller pricing of the safety net, that has been accentuated and compressed in time by the current travails of both banks and thrifts. These developments have affected the supply side of the market for M2 by damping depositories appetites for funds and the demand side through concern over the safety and liquidity of deposits and through the availability of other saving vehicles.

In projecting money growth relative to nominal income and interest rates, the staff has assumed that the unusual strength in velocity will not be reversed, and indeed that there will be further shortfalls in M2 growth relative to growth in income, but the size of these additional shortfalls and associated increases in velocity will gradually decrease. Depositories are expected to become more willing and better able to supply credit as the expansion helps to reduce anticipated loan losses, bolstering their access to capital markets and improving the appetite both of depositories and of depositors for deposits.

This analysis leads us to project 5-1/2 percent growth of M2 for the remainder of 1991 and for 1992, consistent with the greenbook forecast of nominal income and interest rates. Such growth would represent an acceleration from the pace of recent years. As noted above, in the absence of an unexpectedly sharp slowing of inflation, somewhat greater nominal GNP expansion would seem to be needed to reduce the unemployment rate. Even with the more rapid money growth, this projection still implies an increase in velocity, especially in the second half of this year, but to a lesser extent in 1992 as well. Several outside commentators have noted that such an increase in the first part of an expansion would be unusual. In the staff forecast this behavior of velocity has its origin in several aspects of the current situation that differentiate it from past cycles. First is the assumed further downward shift in money demand, or upward shift in velocity. Second is relatively damped downward trajectory of rates in the months leading up to this trough, giving less impetus to money demand--and depressing velocity less--early in this recovery. Third is the decontrol of deposit rates; this is the first recovery we have experienced without any vestige of Regulation Q holding deposit rates below equilibriums or effects of its staged lifting. In fact, the staff expects some, small, further reductions in deposit offering rates in coming months that will raise M2 opportunity costs and contribute to higher velocity.

Against this background, there seems little reason to revise the ranges for 1991 now in place. M2 and M3 are now in the middle portions of their ranges, and under the staff forecast are expected to stay there. In these circumstances, even if the Committee desired a different outcome than the staff forecast, or had questions about the assessment of the economy, prices or money demand underlying that forecast, the resultant adjustments to policy most likely could be accommodated within the current money ranges. Your own forecasts of nominal GNP for the year fall a little short of those of the staff, but, assuming your forecasts were not built on appreciable changes in interest rates, are likely also to involve money growth in the middle portion of the range, considering that the staff projection was for M2 a bit above its midpoint. Moreover, given the factors expected to be boosting M2 velocity in coming quarters, growth around the midpoint in 1991 would seem to be compatible with a policy that was on track to produce the 6 percent nominal GNP growth both you and the staff have projected for 1992. In these circumstances, growth of money--at least M2--approaching the outer edges of the existing ranges this year likely would signal the need to take a hard look at the thrust of policy relative to the Committee's objectives.

The growth of debt so far this year is at the lower end of its range, but is expected to move higher over the second half with the pick up in the economy. A failure of debt to strengthen might signal a problem, such as intensifying restraints on credit supplies, that could affect the performance of the economy. Reducing the debt range at this time could be read as connoting complacency about these kinds of developments in credit markets. On the demand side, desired debt-to-income ratios may well be shifting down as a consequence of wider interest spreads at intermediaries and problems encountered by borrowers over the past year in servicing high debt levels, but such shifts are of uncertain size and duration and should be encompassed within the range.

Alternative ranges for money and debt growth for 1992 are given on page 18 of the bluebook. Alternative I, which would raise the ranges from those in effect this year, would be most consistent with the staff forecast for M2. Raising the ranges would seem to signal that priority was being placed on assuring a fairly robust recovery. The higher upper end of the range would give sufficient room to move against any weakness in the economy should it re-emerge, for example, once the surge from the inventory adjustment is completed. If further reductions in interest rates were needed, the increase in velocity envisioned in the staff forecast would be far less likely. Scope for greater M2 growth would also prove necessary if the recent downward shifts in M2 demand stopped, or especially if they began to reverse. At the same time, the higher range, by potentially accommodating very strong GNP growth, also could be read as connoting less concern about maintaining the downward tilt to inflation in 1992 and beyond.

Alternative II would carry over the current ranges on a provisional basis. Although M3 and debt are projected to grow in the middle of the alternative II ranges in the staff forecast, M2 growth at 5-1/2 percent would be in the upper half of its alternative II range, implying greater scope to run a tighter than an easier policy and higher probability that increases rather than decreases in rates might be needed to hit the ranges. The Committee might want such a bias toward tightening if it were concerned about the potential for inadvertently building in undesired inflation pressures by delaying a needed tightening as the expansion moved out of its initial stages and resource utilization rose. The failure to ratchet down the range as in a number of recent years could be justified by a desire for stronger nominal GNP growth than in the recession and immediate pre-recession years, recognizing that such growth is still likely to be compatible with lower inflation. The central tendency of your own projections is for 6 percent nominal GNP in 1992, the strongest since 1988, with inflation generally below 4 percent and probably headed lower given a 6-1/4 to 6-1/2 percent unemployment rate projected for the end of 1992; if there were little or no increase in velocity, such an outcome would require M2 very close to the top of the alternative II range. Simply carrying over the ranges might also make sense and be explainable in the context of uncertainty about the evolution of the financial system, and its implications for the relationship between money and GNP growth, accentuated at this time not only by the fragile state of many banks and thrifts but also by a pending bill that could affect attitudes toward deposits in ways that are difficult to predict.

Finally, the Committee could reduce the ranges further, as in Alternative III. Such a step would emphasize the Committee's commitment to price stability. The lower ranges imply that the Committee envisions a prompt reaction to any tendency for nominal GNP to exceed its projections, and would tend to constrain and delay any easings undertaken if the economy falls short. Such a course might be seen as potentially compromising the possibilities for a significant recovery over the next year or so, but it would also consolidate recent gains in inflation and keep policy on track to make substantial further progress toward price stability, with attendant longer-run benefits.

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SHORT-RUN POLICY BRIEFING
Donald L. Kohn

With the trough of the cycle now tentatively marked as April, the next meeting of the FOMC will occur in the fourth month after the trough. On occasion in the past, the initial rise in the federal funds rate has occurred by that time in the cycle--though, to be sure, easing also occurred past this point, and past cycles may not provide the ideal model for current policy. The staff forecast, of course, does not envision such an increase this time around, given the other restraining influences discussed yesterday, including the milder degree of policy easing put in place during the recession.

Markets clearly expect some upward movement of interest rates--perhaps not over the next month or so, but probably by yearend. Looking at the entire yield curve, the slope is as steep as in the initial stages of any expansion, even those following more aggressive policy easings. This tilt, and its steepening over recent months, likely does not reflect concerns about a flare-up of inflation, judging from the the appreciating dollar and subdued behavior of commodity prices. But the persistence of high long-term rates in the face of an appreciating dollar and substantial declines in short-term rates could be read as indicating an enduring skepticism about whether lasting progress on inflation can be sustained through an expansion. By implication, markets must be seeing the rise in short-term rates built into the yield curve as an upward movement of real rates necessary to keep inflation from accelerating.

While these expectations might argue for the Committee to be especially alert to the possibility of needing to raise rates over coming months, certain financial flow variables, especially those associated with depositories, continue to flash warning signals about the possibilities of weak expansion. To date, bank credit has been anemic--weaker in fact over the past few months than it was in the first quarter. Growth in total bank credit is usually a leading indicator of business cycle expansions, though business loans often lag the cycle trough. Partial data for June suggest another month of flat bank credit, after allowing for the effects of banks buying thrifts, and further decreases in business loans. While the behavior of loans appears to be mostly a question of declining demand for short-term credit, supply conditions remain tight. Often, the spread of the prime rate over the federal funds rate has begun to narrow appreciably by this point; some times this narrowing has resulted from an initial upward movement of the federal funds rate, but on occasion it has also reflected decreases in the prime in the early stages of expansion. While some banks are reported to be seeking lending outlets a bit more aggressively, that lending seems to be targetted only at the highest quality borrowers. Renewed skittishness in markets for bank debt and equity in the last week may impart a continuing element of caution to bank behavior, even as the economy rebounds.

The fall-off in bank credit in the second quarter has been accompanied by a marked slowdown in M2 growth as well. The moderation in M2 growth in the last few months has appeared to represent not weakness in contemporaneous income or spending, but rather a continuation of the velocity shifts of the past year. Those shifts in turn seem to have their origin in the rerouting of credit flows around depository institutions and, to an extent some portfolio shifts by money holders into capital market instruments, in response to declining yields on M2 assets and the steeper yield curve. The implications of the slowdown in money for future spending depends in large measure on the interpretation of these two phenomena. The portfolio shifts, themselves, seem innocuous, since they do not directly affect spending or wealth. But if they indicate a high level of real long-term rates, weak money may be telling us something about incentives to spend. Similarly, damped credit growth at depositories may simply be a measure of the ready availability of other sources of funds. But if it also connotes banks and thrifts continuing to hold credit conditions quite tight, effective real rates to borrowers may remain high, with implications for spending and growth.

Even with the unchanged funds rates of alternative B, the staff does have a pickup in M2 growth forecast over coming months in association with the strengthening economy, as we discussed earlier in the meeting. Uncertainties about the relationship of M2 to spending over one or two quarters suggest the need to react to any deviations from expectations with care. Nonetheless, continued sluggish money growth, with M2 becoming entrenched in the lower part of its range, might indicate that policy was not fostering the financial conditions needed to sustain moderate recovery, and at least would provide an important counterweight to the expectations of tightening built into the yield curve.